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Arizona Corporation Commission
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May 22, 1998

VIA FACSIMILE
AND HAND DELIVERY

Mr. Ray T. Williamson
Acting Director, Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: Comments on Staff's Statement of Position Dated May 19, 1998; Docket No. U-RE-00000C-94-0165

Dear Mr. Williamson:

As you requested, the purpose of this correspondence is to set forth AEPCO, Duncan, Graham, Sulphur Springs and Trico's comments on the Statement of Position of Staff which was transmitted to us late Tuesday afternoon, May 19, 1998.

Initially, we note that the Statement of Position expands and varies considerably the topics discussed at our May 7 meeting with Staff. For example, provider of last resort and the transmission and dispatch issues set forth at pages 5 to 7 in the Statement of Position were never even mentioned during our meeting. This new and different material, coupled with the fact that Staff has requested comments in less than three working days from transmittal, severely limits our ability to be comprehensive in this response.

We are also concerned about the procedural posture of this matter and, in that regard, share the concerns which were set forth in Citizens Utilities' May 14, 1998 letter to you. As you know, the Commission commenced a contested evidentiary proceeding late last year on stranded costs. All parties, including Staff, expended a tremendous amount of time and resource presenting the Commission with evidence and testimony on many stranded cost issues. The Hearing Officer has recently issued a Proposed Opinion and Order and exceptions to it are due May 29, 1998. Now, we have been told that this proceeding will instead be used as the vehicle for Commission consideration and possible adoption of Staff's Statement of Position. At best, this procedure is confusing, prejudicial to the parties who participated in good faith in the stranded cost proceedings and extremely wasteful of both the parties and the Commission's resource. At worst, it violates due process requirements and several Commission rules including, but not limited to, R14-3-110 and R14-3-113.

In fairness, we would ask that the Commission promptly advise us and other parties to the stranded cost proceeding whether we should continue to expend time and effort on the Hearing Officer's Proposed Opinion and Order, whether this matter is now considered a rules proceeding not subject to the ex parte provisions of R14-3-113 and what the nature of the June 3, 1998 Open Meeting will be.

General Concerns.

The result of the Positions, taken together, will be to significantly increase the costs of delivered electricity to the majority of Arizona consumers, particularly residential customers, take generation out of the hands of Arizona companies and turn it over to out-of-state interests. This is because each Position adds an extra cost as detailed below, whether from higher power costs because of the divesture procedures and rules chosen, through inefficient separation rules and duplication of billing efforts to requiring use of the highest cost form of purchase power contract and the most costly ISO structure. The Positions unfairly require compliance by Affected Utilities, not all electric service providers. Thus, a new market entrant, with out-of-state generation, may coordinate its competitive sales in Arizona with its regulated activities elsewhere sharing employees, plant, and generation capacity in both endeavors, giving it a competitive advantage and enabling it to offer lower prices than the Affected Utilities which are burdened by these regulations.

Before proceeding to specific comments and/or questions relative to the Statement of Position, we set forth several general concerns:

- The Commission does not have the jurisdiction to order, among other things, divestiture of assets, nor to dictate the organizational structure of utilities subject to its jurisdiction. In several cases Arizona courts have reminded the Commission that: (1) the Commission's authority does not extend to running the utility and (2) the power of government to regulate public service enterprises should not be confused with owning and managing those enterprises.

- It appears that while the Staff Statement of Position maintains that divestiture of generation assets is not required, it nonetheless requires divestiture as a condition to recovery of stranded costs. If true, such a requirement would be unconstitutional, beyond the Commission's power as previously explained and a violation of the Cooperative's property rights guaranteed by both the Arizona and United States' Constitutions.

- The Statement of Position contains several irrebuttable presumptions. They are disfavored in the law and they are factually unsupported as well. For example, the prohibition against any Affected Utility or its affiliate purchasing generation assets at any divestiture auction is both unwise and unsupported. Why would the Commission want to remove from the bid process local utilities which are most familiar with and most interested in serving the Arizona market? A primary effect of such a restriction would be to artificially depress bid prices for assets by limiting the field of bidders, thereby driving stranded costs higher and increasing costs for consumers.

- The Cooperatives are aware of no record evidence which supports the Statement of Position's blanket assumption that vertical or horizontal market power is a problem in Arizona.

- The Statement of Position is problematic in a wide variety of other ways including, but not limited to, assuming to the Commission general law making, judicial and antitrust jurisdiction and interfering with Federal Energy Regulatory Commission jurisdiction.

The Cooperatives do not raise these points in an attempt to be legalistic in their approach to or response concerning the Statement of Position. Rather, they raise them in a good faith attempt to alert Staff to the fact that there are serious legal and factual problems with many of its proposals. If, indeed, the intent is to release the Statement of Position on May 19 and only two weeks later seek Commission authorization to adopt rules consistent with it, this course of action is doomed to create even more litigation, more uncertainty and more delay in the transition to a competitive marketplace.

<u>Comments on Specific Positions</u>.

The Cooperatives will now offer comments on specific positions by subject matter. Once again we stress that the limited time for response has severely restricted our ability to be thorough. For convenience, attached is my May 12, 1998 letter to Mr. Rose on certain of these subjects.

A. <u>Stranded Cost</u>.

Our questions on this subject include:

- With the exception of the waiver/transition revenues provision in the final paragraph of this section, must a utility divest in order to recover stranded costs?
- As to the final paragraph, what criteria would control whether divestiture is not "practical and not in the public interest"; what criteria would be used to determine adequate "transition revenues"; and how would the Commission determine if transition revenues are in the public interest?
- What study, if any, has been conducted on the subject of vertical and horizontal market power in Arizona?
- What would be the market price effect of forcing several thousand megawatts of generation assets to be sold in less than one year?
- What is the market price effect of excluding all Affected Utilities from the bidder's pool?
- What entities would be preferred by this approach and what study has been undertaken as to their post-divestiture horizontal or vertical market power?
- What are the estimated costs of the sales which will be borne by consumers, both in terms of stranded cost recovery and higher energy prices?

Requiring divesture as a condition of recovery of stranded cost is unfair, unwise and unlawful. In the Cooperatives' case, it would force AEPCO, its distribution member-owners and their customer-owners to surrender efficient, low cost generating assets and face both the supply and price uncertainties of a market that may not be interested in rural Arizona. AEPCO's members and their customer-owners have supply contract rights in AEPCO's generating facilities which cannot be ignored or impaired. Similarly, the United States government and other lenders are unlikely to authorize sale of AEPCO's generating assets.

The final paragraph of this section dealing with "transition revenues" might be appropriate for AEPCO. However, before the Cooperatives could support such a proposal they would need additional detail on what showing will be necessary to demonstrate that divesture of any particular generation asset is not practical and not in the public interest. Also, precisely what is envisioned by the terms "transition revenues" sufficient "to preserve its financial integrity..."? Also, what criteria would the Commission apply in determining whether the transition revenues are in the public interest?

We are also not certain what is intended by the statement "any mechanism used for the recovery of stranded cost shall be competitively neutral." As to the requirement to move non-divested generation to an Affiliate, the restructuring plan currently being considered by AEPCO and its members contemplates instead transferring its transmission assets to a corporate affiliate. Would this be an alternative?

Regulatory assets must be given assured recovery treatment. They are sunk costs incapable of being mitigated which have been deferred for future recovery. In AEPCO's case, they consist mainly of fuel resourcing costs and refinancing expenses which have produced and continue to produce significantly lower energy costs for its members and their customer owners. 100% recovery of regulatory assets must be assured.

No provision is made for distribution cooperatives and the stranded costs they may incur in the competitive market. What provision for recovery will be made for them? We have previously suggested a new subsection in R14-2-1607 that would permit distribution stranded costs to be determined and recovered after competition occurs.

Finally, the provision that special contract customers will not be assessed stranded cost or transition revenues during the term of the special contract, but instead such charges will be borne by the Affected Utility makes little sense. Although it would be a boon for special contract customers, why should they escape such charges when other customers must bear them? On the other hand, if standard offer customers do not pay a stranded cost assessment then contract customers should not either, but utilities should in no event absorb their portion. Requiring the utility to absorb stranded cost charges alters the terms of the agreements between the utility and its customers in violation of, inter alia, A.R.S. §40-252 and also unlawfully impairs the obligations of those contracts.

B. **Affiliate Rules.**

The Cooperatives are not certain how much, if any, of this section is intended to apply to them. Obviously, generation/transmission functions are already separated from distribution in the cooperatives' structure. Also, the Commission's current Affiliate Interest Rules apply only to investor-owned utilities. The Cooperatives see no reason to apply these requirements to them, particularly since there is no conflict between owners and customers in the cooperative's structure. The primary reason cooperatives will enter competitive markets will be to replace revenues lost to the competitive market so as to hold down their customer's rates. Needless duplication of staff and plant will thwart that effort.

In general, the Cooperatives feel a blanket requirement that all competitive and regulated activities be accomplished through separate subsidiaries will significantly drive up costs for consumers. For example, under the Statement of Position the Commission would not allow a plant or other resources to be used both for competitive and regulated activities. This will be tremendously inefficient and will deprive both sets of customers of the gains associated with coordination. It makes no business sense to limit a generation unit's output solely to standard offer sales when it has the capacity also to serve competitive sales. Customers of both will benefit from the production efficiencies in terms of heat rates, fuel costs and operating personnel. Nor does it make sense to hire two sets of billing clerks, one to bill standard offer sales and one to bill competitive customers. There also is no reason to believe that traditional accounting safeguards and other measures could not be used instead to separate functions and identify and allocate costs. This is a more efficient solution than the problems and inefficiencies inherent in the blanket requirement that all activities be conducted through affiliates or subsidiaries. The Commission has for years satisfactorily used such accounting mechanisms, for example, to separate jurisdictional and nonjurisdictional activities. The prohibition relating to joint marketing is also undesirable.

The Cooperatives strongly urge the Commission not adopt such a broad separation requirement, particularly at this early stage and without any evidentiary record to support the need, efficacy or desirability of such a requirement.

C. Implementation of Competition.

The Cooperatives believe it will be feasible to provide customers with loads of 1 MW and above access to competitive electric power on January 1, 1999. However, they are less certain, from a practical standpoint, that aggregated loads greater than 20 kW to achieve the 1 MW threshold could be accommodated on that same date - particularly given all other tasks which must be accomplished.[1] They also believe that general market access to competitive electric services on January 1, 2001 is achievable.

As to the residential phase-in program, at our meeting Staff indicated that the residential phase-in program would apply only to investor-owned utilities, not Cooperatives. Is this statement still accurate? If not, the Cooperatives are unable to indicate at this time whether the residential phase-in program could be accomplished.

As to targeted rate decreases, over the past 12 years, AEPCO has decreased wholesale rates by more than 21% and in addition has returned some $16 million in cash refunds to its member-distribution Cooperatives. These benefits have already been and continue to be passed through to the customer-owners of AEPCO's member-distribution cooperatives. Many of the Cooperatives have some of the lowest electric rates in the state despite the fact they serve the highest cost areas. We offer these comments to illustrate that cooperatives are certainly not opposed to rate decreases.

However, the Commission simply has no authority to order across-the-board rate cuts. Most of the Cooperatives have not requested rate increases for many years. Either rate increases or, at a minimum, rate stability are necessary to preserve the financial integrity of the Cooperatives and/or to make necessary improvements to their distribution systems.

[1] Such aggregation, however, is believed to be unconstitutional.

D. Metering and Billing.

Our questions on this subject include:

- Who is developing the EDI?
- Who is going to pay for it?
- Will the customer bear the cost of competitive metering?

As to billing, the Cooperatives believe the Affected Utilities should issue one bill with the energy portion of the bill being supplied to the Affected Utility by the energy service provider, if different than the Affected Utility. Also, the statement that the Affected Utility is the only entity that can order connects and disconnects implies that it is also the only entity that is allowed to read the meter. That being the case, then the billing should logically come from the Affected Utility.

E. Local Distribution Company Services.

These provisions are completely new and time has not allowed any detailed analysis of the proposal. Although the Cooperatives do not object in concept to being the provider of last resort, the subject needs much consideration and refinement. In particular, acquiring power purchased to serve standard offer customers through competitive bid by contracts containing provisions to ratchet down power purchases will be outrageously expensive. Such a requirement also violates and impairs the obligations of the AEPCO/member distribution all-requirements contracts. The Cooperatives strongly feel it is in their consumer-owner's best interests to continue to meet their standard offer obligations through the relatively low cost power offered by AEPCO.

As to the requirement that a customer could change suppliers at the end of the billing cycle with no constraints, this is particularly ill-advised. It will allow sophisticated consumers to "game" the system at the expense of the standard offer customer. It will also drive up standard offer costs and make more unpredictable, and therefore more costly, the power utilities must have available at a moment's notice to meet standard offer obligations. At a minimum, there must be reasonable notice requirements from customers electing to change suppliers.

As to system benefits, the costs of fossil plant decommissioning should be financed through the systems benefits charge as well.

F. Transmission and Dispatch.

The Cooperatives agree that open access to transmission and distribution facilities should be non-discriminatory. For many reasons, however, the requirements that all utilities join an independent system operator (ISO) and participate in an Independent Scheduling Administrator (ISO) are jurisdictionally problematic, premature, costly and unwarranted.

First, reliability and implementation of the rules does not require the formation of either an ISA or a ISO. What is required for reliability and safety of the transmission system and timely access is resolution of the 31 items identified by the Reliability Group and reported to the Commission 17 months ago along with eight agreements and seven protocols. These matters have still not been resolved.

Second, the proposal is premature and duplicative. As participants in the Desert STAR (ISO) Work Groups, all interested entities worked for almost a year developing a "strawman" ISO, prepared a feasibility report and then decided to move to a formation study of a regional ISO for Arizona, Nevada, New Mexico and non-ERCOT Texas. It is estimated that $35 million will be needed to start the ISO and $18 million will be needed annually to run it. This amount is an additional charge that will need to be recovered from customers above what they now pay for transmission service.

Third, the concept will simply not do the job. The proposal requires only the Affected Utilities (with transmission) APS, TEP, CUC and AEPCO to participate in the establishment and operation of an ISA/ISO in Arizona. Such an entity would be ineffectual since only a fraction of Arizona's transmission would be included, an amount insufficient to achieve the purpose of the ISA/ISO. Left out would be the entire Western Area Power Administration transmission system, the vast system of SRP, and the jointly owned Arizona transmission lines of such entities as Southern California Edison, Los Angeles Department of Water and Power, Nevada Power and Public Service Company of New Mexico.

Fourth, the proposal is vague and impractical on implementation details. No ISA/ISO is needed by January 1, 1999 to enable retail access. Retail access can be accommodated by the existing control areas until such time as another system may be needed. It takes time to properly develop an ISA or an ISO that is agreeable to all entities. Additionally, any operation or proposed operation of the transmission system within Arizona is FERC jurisdictional and FERC approval must first be had before establishment. For California, that process took more than two years, with changes required in the planning before the ISO could be structured.

Fifth, it is quite possible, due to the California ISO debacle, and experiences of others that an ISO may not form within the Desert Southwest and the concept of an ISA may provide a less costly method to meet the concerns of marketers, meet the desire of utilities to ensure independent operation of the system and provide an efficient cheaper way to resolve disputes. IndeGo, an ISO in the formation state in the Northwest, recently disbanded due to the enormous start-up costs, projected to be in excess of $100 million. IndeGo participants were unwilling to subject their consumers to the costs that would be associated with the ISO, even though they would be rolled into the tariff of IndeGo. The cost of the California ISO has not been formally stated, but it is generally believed to be in excess of $300 million.

Finally, the must run proposal needs much more definition. As is, it would render such stations mere "pump stations" and eliminate their ability to be meaningfully involved in the market place.

<u>Conclusion</u>.

The Cooperatives are prepared to continue to participate collegially in any process the Commission believes would help resolve issues and produce viable solutions. Please contact me if I can provide additional information on any of these subjects.

Very truly yours,

Michael M. Grant

By
Michael M. Grant

Enclosure

Original and ten (10) copies
filed with Docket Control

cc: Chairman-Commissioner Jim Irvin
Commissioner Renz Jennings
Commissioner Carl Kunasek
Jerry Rudibaugh, Esq.
Pat Cooper, Esq.
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All parties of record/Stranded Cost Docket

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May 12, 1998

VIA FACSIMILE
AND U.S. MAIL

Mr. Jack Rose
Executive Secretary
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: Competition Rules Revision Proposals

Dear Jack:

As you requested at our meeting last Thursday afternoon, the purpose of this letter is to provide AEPCO, Duncan, Graham, Trico and Sulphur Spring's initial reactions to the four rules revision proposals Staff outlined. Because the details were sketchy and nothing was provided in writing, to attempt to avoid any miscommunication I'll first outline my understanding of the proposal and then provide a reaction.

1. Stranded Cost Proposals: Two options were presented. Under the first, divestiture of generation assets would be tied to full recovery of stranded costs. An interim Competition Transition Charge would be imposed beginning January 1, 1999 with a one-time true-up on January 1, 2000 assuming a sale next year. Under the second option, Affected Utilities which do not divest would be limited to 50% of stranded cost recovery on some type of net revenues lost calculation method. Staff is not certain how regulatory assets would be treated under either proposal. Under both, a 5-10 year recovery period is contemplated.

Reaction: Neither proposal is fair nor makes sense for cooperatives and their owner customers. Even assuming the federal government, bondholders, creditors and AEPCO's members would consent to sell the generating assets, the distribution cooperatives would be left with no assured source of power (1) to serve their 300,000 rural customer owners and (2) to meet the Rules' continuing obligation to serve. Rural customers would be at the mercy of the market, both as to price and even availability of power. The second proposal could trigger major write-offs at the AEPCO level and possible default on its mortgage and other debt instruments. With no shareholders to absorb the 50% write-off, AEPCO would be required to raise its rates - both standard offer and competitive - creating more stranded costs and a death spiral as those rates exceed market price.

All witnesses on behalf of all parties agreed that different solutions on stranded costs were appropriate for cooperatives because, among other things, their customers are their owners and they have no profit motive. We would suggest a net revenues lost total recovery method or possibly a variant of Staff's "transition revenues" approach that would account for those differences. Also, separate consideration must be given to recovery of stranded costs at the distribution cooperative level which may or may not develop only after competition is actually implemented. Therefore, the Cooperatives recommend that a new subsection be added to R14-2-1607 which expressly provides that application may be made by an Affected Utility as to stranded costs arising after competition is implemented.

2. Metering Proposal: Competitive metering would commence January 1, 1999 but providers would be limited to (a) the utility, (b) the ESP or (c) an agent of the ESP. Removed meters would be eligible for stranded cost recovery; at the customer's option any new meter would be supplied at the customer's expense; and under no circumstances would a distribution utility be required to supply a different meter.

Reaction: The proposal seems reasonable but several details/questions which we discussed need clarification. Customer ownership of the meter is probably not a good idea. In general, the cooperatives believe that adding competitive metering, billing and collection to an already crowded list of agenda items is not good policy. Also, the tax provisions of HB 2663 will not work if the distribution utility does not perform the metering and billing function.

3. Affiliate Organization Rules: Rules' amendments would require structural, not just accounting, separation of competitive and non-competitive services.

Reaction: Structural separation and disaggregation are already present in the cooperatives' G&T/distribution organization model. Further, AEPCO and its members are actively examining possible further restructuring of AEPCO. However, requiring further separations, especially at the distribution level, will undoubtedly create tax exemption and funds flow problems which will not serve any useful purpose. Additionally, structural separation will substantially increase costs by adding unnecessary, duplicative levels of administration and staffing.

4. Competition/Phase-In: Rather than the 20%/50%/100% current Rules' schedule, effective January 1, 1999 all loads greater than 1 MW would be opened to competition with full competition implemented January 1, 2001. A small residential pilot program might also be required of the investor owned utilities. APS and TEP rate sharing/cost reduction agreements would remain in effect, possibly producing further rate reductions for customers.

Reaction: This proposal certainly is more realistic than the current timetable and also avoids its technical, operational and customer selection problems by postponing large scale competitive access. Among other things, it gives all of us time to work out and test access procedures. We would recommend, however, loads greater than 3 MW for its first phase.

I understand the Staff plans to circulate a more detailed written proposal next week with the objective being to provide a product for the Commission's review next month. More specificity will be helpful and would provide a precise proposal that could be discussed with the cooperatives' Boards of Directors. The Cooperatives will be ready to participate further in this process.

Very truly yours,

By Mike

Michael M. Grant

cc: Pat Cooper, Esq.
Russell Jones, Esq.
Chris Hitchcock, Esq.
Mr. Jack Shilling
Mr. Nelson Peck
Mr. Tom Jones